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OFFICE OF THE SECRETARY

Mr. Jonathan G. Katz
Secretary
U.S. Securities & Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: SRO Response to Comment Letters filed regarding SR-BSE-2002-15, Rules of the Boston Options Exchange

Dear Ms. Nazareth,

The Boston Stock Exchange, Inc. ("BSE" or "Exchange") appreciates this opportunity to respond to issues raised in various comment letters responding to the above captioned filing. The Exchange was extremely pleased at the high level of support offered for its proposed facility, the Boston Options Exchange ("BOX"), in almost 90% of the 276 comment letters submitted by various competing options exchanges, market participants and trading firms (collectively "Commentators"). The Exchange welcomes the commentary offered by various competing options exchanges, aside from obviously political and anti-competitive commentary, as it will help to shape how BOX competes in the options arena following its impending launch.

In response to comments, the Exchange herein sets forth its explanation and justification for what it perceives to be misunderstandings or misconceptions on the part of various Commentators, particularly the existing options exchanges, about BOX and BOX's Market Model. The Exchange will also discuss some of the changes made to its proposed BOX Rules, primarily as a result of ongoing discussions with Securities and Exchange Commission ("SEC" or "Commission") Staff ("Staff"). The Exchange believes its response to issues raised by Commentators as well as the changes to its proposed BOX Rules will lay the groundwork for Commission approval of these Rules. The Exchange is optimistic about the impending launch of an options market, which is not only refreshingly innovative, but designed for the ultimate and immediate benefit of the investor.

The essence of BOX is to apply the latest technology and a new market structure to bring competition and transparency to the growing trading of options for NYSE and Nasdaq stocks. BOX is a remote-access, all-electronic marketplace that will provide speed, anonymity, and accuracy of data. There is no trading floor. There is no requirement to buy or lease seats to become a specialist or market maker. Moreover, Market Maker appointments are not limited as they are at the existing options exchanges. Plus, fill automation will provide BOX with a powerful electronic audit trail and monitoring system to surveil the market for fraud or any unfair trading practices.

In response to the BSE's BOX proposal, the existing options exchanges have mounted a disinformation campaign in an attempt to preserve their monopoly specialist systems. At the center of the campaign has been the claim that BOX will institutionalize "internalization" and was created so large trading firms can profit by earning fees on both sides of the trade. The proposed BOX Market is actually the antithesis of internalization in this sense, as it provides, through an automatic three second price improvement process, for exposure of orders to multiple Market Makers and public customers. Any competitor can match or improve the price and grab part or all of the order.

The Exchange explores below each of the various issues raised by Commentators in response to the proposed BOX Rules. In this analysis, the Exchange will highlight the following fundamental facts regarding the proposed BOX Market:

- BOX's multiple Market Maker structure will foster competition for order execution.
- BOX offers superior opportunities for real price improvement of customer orders.
- BOX's overall low costs and easy access to required technology will make it easy for small firms to compete.
- The openness of BOX's structure is underlined by the fact that, as of the end of October 2003, 32 firms were conditionally approved and allocated class appointments for market making on the first 250 classes to be listed. On average, BOX will have 14 Market Makers per class after the first six months of trading (ranging from ten to 26). That is significantly more competition than elsewhere. As of the end of October 2003, nearly 100 firms have applied to be BOX Options Participants.
- On BOX, the wheel and specialists have been eliminated in favor of an anonymous price-time priority book.
- On BOX, there will be no exchange sponsored Payment for Order Flow. Accordingly, investors will be able to directly and immediately benefit from the introduction of the BOX Market.
- The BOX Market is not based on whom you know or who you are but when your order arrives at its electronic order book.

The Exchange sets forth its assessment of the major issues addressed in various comment letters below and has provided its views on each. As appropriate, the Exchange has also noted those areas in which it has made changes to the proposed BOX Rules.

INTERNALIZATION / FACILITATION

Existing options exchanges argue incorrectly that BOX will facilitate internalization which will drive Market Makers out of the market and ultimately degrade market quality. They portray today's markets as vibrant and competitive with many Market Makers vying to provide liquidity. [1]

It is widely recognized that there is inherent value in customer order flow. Particularly with respect to the $.05 to $.10 minimum price increments that currently exist in the U.S. options market. The real issue is how best to allocate this value between and amongst customers, brokers, specialists and Market Makers while at the same time balancing the need for efficient and fair pricing and the need for sufficient incentive to liquidity providers. On existing options exchanges, order flow providers ("OFPs") decide which of their order flow to internalize or facilitate and which to sell or lay off to other specialists, Designated Primary Market Makers ("DPM") or the like. Most major OFP firms, such as Goldman Sachs, Morgan Stanley and Interactive Brokers, among many others, have become specialists and Market Makers on the various competing options exchanges. Accordingly, these entities already can decide which orders they wish to trade against and which to send to other specialists or Market Makers on other options exchanges.

Firms that want to internalize or facilitate on the existing options exchanges simply send their order flow to affiliated specialists or DPMs. Furthermore, OFPs unable to internalize through affiliated specialists and Market Makers instead sell their order flow for payment or for return business in the form of clearing, block shows or other consideration. Customers are unable to recapture any of the price spread given the $.05 increments, and in fact, small orders are automatically executed at the Next Best Bid Offer ("NBBO") with no mechanism for price improvement.

There are several factors tending to inhibit opportunities for price improvement. Some of which include: (1) passive automatic execution ("Auto-Ex") wheel systems; (2) the difficulty of crowd members to post prices quickly; (3) little or no allocation advantage for a crowd participant to better the price; (3) rules discouraging customers from bettering the market price, such as fifteen second speed bumps; as well as (4) other rules preventing electronic generation and transmission of orders. The vast majority of customer orders continue to simply be printed at the NBBO with

[1] See generally, February 28,2003 Letter from Philip DeFeo, Chairman and Chief Executive Officer, PCX, to Jonathan Katz, Secretary, Commission regarding SR-BSE-2002-15 ("PCX letter 1"); February 14,2003 Letter from William Brodsky, Chairman and Chief Executive Officer, CBOE to Jonathan Katz, Secretary, Commission regarding SR-BSE-2002-15 ("CBOE letter 1"); February 14,2003 Letter from Michael Ryan, General Counsel, AMEX to Jonathan Katz, Secretary, Commission regarding SR-BSE-2002-15 ("AMEX letter 1"); February 12, 2003 Letter from Michael J. Simon, Secretary, ISE to Jonathan Katz, Secretary, Commission regarding SR-BSE-2002-15 ("ISE letter 1"); February 12,2003 Letter from Meyer S. Frucher, Chairman and Chief Executive Officer, PHLX, to Jonathan Katz, Secretary, Commission regarding SR-BSE-2002-15 ("PHLX letter 1").

no competitive mechanism to improve prices. BOX presents the best solution for enhancing customer opportunities for price improvement in the options market.

BOX is a technologically advanced, cost-efficient platform with well-populated Market Maker class allocations. All BOX Participants have incentives to act competitively. These incentives are: (1) order flow providers can interact with their own orders when price improvement is provided; (2) Market Makers can also compete through competitive pricing for the lion's share of those orders; (3) there is an electronic price improvement process that will enable customers an opportunity to benefit from a narrower spread, gaining price improvement; and (4) there is incentive to be the first to post the NBBO to become the Market Maker Prime (MMP), which encourages a narrower NBBO. Rather than Market Makers simply printing the attractive orders at the NBBO and giving up a piece of the spread through payments to OFPs, as is the practice on other options exchanges, OFPs and Market Makers on BOX will have to compete through the Price Improved Period (the "PIP"). Customers will receive better prices because of the PIP process and the MMP mechanism.

BOX's proposal has been further improved through Staff suggested amendments. Every auction must start one penny better than the NBBO. This means all public customer orders submitted to the PIP will be executed at a price better than would have otherwise been possible had BOX not existed. On BOX, Market Makers will compete at $.01 increments better than the NBBO and may only participate if equal to the best PIP price at its conclusion, thereby making it easier for other firms besides the facilitator to participate in the order. The 40% to the would-be facilitator can only occur after the PIP, during which Market Makers and public customers are free to compete for the trade. A PIP initiating firm gets no last look at the price before determining what to bid or offer and thus cannot guarantee a specific percentage or <u>any</u> percentage, not even 40%! Also, a PIP initiating firm on BOX cannot cancel a PIP if the market suddenly moves against it, unlike facilitation on the other options exchanges, as the customer order is 'stopped' at the PIP initiated price. In short, there is simply no existing counterpart to the proposed BOX model, which would allow for guaranteed price improvement.

The PIP is an objective and electronically transparent opportunity to compete for orders through price improvement initiatives. There is absolutely no basis in fact or any evidentiary support for the spurious claim that BOX will somehow discourage market making or drive participants out of the market.[2] As a remote access options exchange with much lower overhead and trading costs for participants, BOX will improve overall liquidity and encourage smaller Market Makers to compete. In fact, BOX is currently attracting Market Makers who have been locked out of the allocation processes on the existing options exchanges. On October 18, 2003, the Exchange executed its initial class allocation to 31 Market Maker firms. There are over 20 more Market Maker firms, altogether representing every major U.S. Market Maker, who have applied for membership on BOX with numerous other applications for participation as OFPs having been

[2] ***See generally,*** **PCX letter** 1, **CBOE letter** 1, **AMEX letter** 1, **ISE letter** 1, **PHLX letter** 1.

accepted. The BOX Market Model is obviously an exciting and attractive venue for Participants to compete for orders.

P FOR ORDER FL(

It has been suggested that the PIP will encourage Payment for Order Flow?

As an unintended benefit to the **U.S.** options markets, the PIP process may very well be the mechanism which could lead to the elimination of Payment for Order Flow. Understandably, Payment for Order Flow is **a** controversial subject, often avoided by the existing options exchanges, especially those which institutionalize Payment for Order Flow. In 2000, the SEC commissioned a special study about Payment for Order Flow and internalization in the options markets and found "Payment for [O]rder [F]low is a method of transferring some of the trading profits from market making to the brokers that route customer orders to specialists for **execution"**[4] and funds generated from Payment for Order Flow and internalization ideally should be past onto the customer in the form of "reduced costs".' "[Flew firms are passing along the benefits of payment for options order flow to their customers in the form of either reduced commissions or **rebates."**[6] In fact, the Commission determined that a more sinister development emerged with the introduction of Payment for Order Flow into the options market:

> "[P]ayment for [O]rder [F]low and internalization contribute to an environment in which quote competition is not always rewarded, thereby discouraging the display of aggressively priced quotes. In the multiple trading environment specialists on the competing options exchanges typically will promise to match the displayed prices of other exchanges. If widespread, these passive [price matching] practices may weaken the incentive to display competitive quotes, because displaying a superior quote does not necessarily ensure attracting additional order flow. Over time, therefore, the quotes being matched may become wider, increasing execution costs to **investors."**[7]

The Commission's Office of Compliance Inspections and Examinations ("OCIE") has also explored this area and found that "Payment for [O]rder [F]low has had [a negative] impact on order routing decisions."[8] The Commission's Office of Economic Analysis **("OEA") has** also determined that in addition to cash payments for Payment for Order Flow other inducements also

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[3] **September 12, 2003 Letter from Michael J. Simon, Vice President and Secretary, ISE, to** Jonathan **Katz, Secretary, Commission regarding SR-BSE-2002-15, 2 ("ISE letter 2").**
[4] **SEC,** ***Special Study: Payment for Order Flow and Internalization in the Options Markets,*** **4** (Dec. **2000),** ***available at*** http://www.sec.gov/news/studiedordpay.htm.
[5] ***Id.***
[6] ***Id.***
[7] ***id.***
[8] ***Id.*** **at 6.**

exist, such as increased profits at affiliated firms to which order flow is directed and reciprocal order flow arrangements.'

CBOE, the self proclaimed "world leader among options exchanges[,]"[10] and the undisputed ruler of the U.S. options market, single handedly collected $19.3 million in marketing fees for Payment for Order Flow for the year ending June 30, 2002.[11] "On July 1, 2000, [CBOE] imposed a $.40 per contract marketing fee on market makers and DPMs when executing transactions with [non-CBOE] market makers. This fee was suspended effective August 1,2001, however [CBOE] still facilitates the collection of [P]ayment for [O]rder [F]low funds from DPMs and distributes order flow funds to order provider firms, as directed by the DPMs each month."[12] In 2001, CBOE collected $80 million in marketing fees for Payment for Order [F]low.[13] CBOE's 2000 Annual Report boasts of their "[continued] record volume and increased automation [which] allowed CBOE to pass on savings to the customer"[14] but does not specify how the savings were allegedly passed onto their customers, nor does it provide any statistical data to support their assertion which conflicts with the Commission's own special study.

The Exchange's response to this issue is simplistic, but complete and effective. The BSE will not sponsor any Payment for Order Flow program in the proposed BOX Market. As a result, the Exchange has estimated that investors can save over $100 million annuallv in Payment for Order Flow fees alone by trading on BOX. In addition, BOX Market Makers' best quotes will be quickly displayed and automatically executed against the entire BOX Market incoming order flow. Through the PIP, Market Makers assigned to the class or quoting at the best bid or offer on BOX will have every opportunity to participate in the executions of customer orders that were not directed to them and for which they do not have to pay to attract to their market. The Exchange would encourage all of the existing options exchanges to abandon Payment for Order Flow practices in their own markets rather than speculating that the PIP, and BOX in general, will somehow foster the practice. This position is at best speculative and at worst disingenuous and deflective of the real problem that currently exists at their respective options exchanges. Through BOX, the BSE is providing a solution to the other options exchanges to end this practice, which benefits market makers and specialists to the detriment of the public investor.

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[9] *Id.* at 12-13.
[10] CBOE, *State of the Exchange: Chicago Board Options Exchange Annual Report 2002,* 1 (Dec. 2002) *available at* http://www.cboe.com/aboutcboe/annualreport2002.
[11] *Id.* at 18.
[12] *Id.* at 19.
[13] *Id.* at 18.
[14] CBOE, *A Floor WithoutA Ceiling: Chicago Board Options Exchange Annual Report 2000,* 2 (Dec. 2000) *available* at http://www.cboe.com/aboutcboe/annualreport2000.

<u>THE PR OVEME PERIOD (' "P</u>

Some Commentators have focused on the PIP and asserted that this proposed price-improvement mechanism violates various sections of the Securities Exchange Act of 1934 (the "Act") and other commonly accepted and practiced rules. The Exchange offers the following responses to specific comments to aid Commentators in their understanding of how the PIP does not violate any provisions of the Act but will greatly benefit investors.

The ISE opined the PIPs should not be allowed for small orders. Specifically, the ISE claimed that by allowing smaller orders to participate in the PIP and removing small customer orders from an exchange's general auction could adversely affect the auction generally and the pricing mechanism.[15]

There is no basis upon which the pricing mechanism of the auction market would be adversely affected by the routing of small orders to an automated price improvement mechanism. The PIP is premised on the same principles of price competition in an auction market. On ISE, a PMM can internalize or facilitate 100% of all small orders under five contracts at the NBBO. An order executed through BOX's PIP enables the competing market making crowd an opportunity to submit price improvement orders and get anywhere from 60% to 100% of an order which they did not initiate. The initiating firm is limited to 40%, if others compete at the same price for the remainder of the order.

One of the most attractive features of the "pricing mechanism" of BOX's PIP is the efficiency of delivering executions better than the NBBO regardless of whether it is a small or large order. Most small orders represent public investor orders and for the most part are executed at the NBBO. BOX's PIP provides a viable and competitive alternative to the current options market pricing mechanisms and that is undoubtedly one of the reasons that BOX's PIP has been met with such intense resistance from the existing options exchanges who oppose its activation and what it would mean for them.

Comment letters have suggested the PIP violates the Firm Quote Rule because during the PIP, BOX is disseminating bids and offers internally to BOX Participants but not to the investing public.[16]

The PIP is a price improvement mechanism and does not implicate the Firm Quote Rule. Price improvement initiatives of competing PIP participants are <u>not</u> available to the public, unlike actual "quotes" that are subject to the Firm Quote Rule. The PIP process is akin to price improvement algorithms currently in place on most equities exchanges, including the Exchange. These algorithms result in improved prices to the customer better than the NBBO. However,

[15] ISE letter 2 at 3.
[16] *Id.* at 5; See *also* February 12,2003 Letter from Meyer S. Frucher, Chairman and Chief Executive Officer, PHLX to Jonathan Katz, Secretary, Commission regarding SR-BSE-2002-15, 2 ("PHLX letter 2").

these algorithms are not reflected in the quote. The Commission has consistently viewed such mechanisms as a public benefit and not covered under the Firm Quote Rule.

On BOX, PIP prices are available to all BOX Participants but not available to the Options Price Reporting Authority ("OPRA") because they are price improvement initiatives. Additionally, OPRA's industry wide quotes are managed at $.05 and $.10 cent increments. Absent a Commission directive or industry-wide initiative, BOX does not intend to introduce penny quote increments into the options marketplace.

In related commentary, it has been suggested that since the PIP is only broadcast internally to BOX Participants, there is no possibility of real competition." PIPs however, are very different and much more transparent than common practice on other options exchanges. For instance, on the ISE, facilitation "auctions" are broadcast only to Competing Market Makers ("CMM") and PMMs on the particular bins. On the floor-based exchanges, of course, there is no broadcast and only those who are physically present in the pit will be aware and able to compete in order facilitations. In contrast, all BOX Participants will be aware of the occurrence of a PIP on BOX, although only Market Makers on the class, OFPs that initiated the PIP, Proprietary Improvement Orders ("PPOs") and Customer PIP Orders ("CPOs") (as discussed below) will be able to submit orders in penny increments.

Other options exchanges feel the PIP process should not take place in pennies even though there is a general begrudging acceptance PIP guarantees price improvement in penny increments. The ISE stated in its letter it understood "the rationale for having a PIP auction inside the standard increments."" Likewise, the American Stock Exchange, Inc. ("AMEX") also commented that one-cent increments within the PIP offered price improvement "over the NBBO."[19]

As discussed above, the goal of PIP is to allow the return of some of the value inherent in customer order flow directly to the customer. Pennies allow narrower pricing initiatives within the PIP and thus allow Participants to capture some of this value and rebate it to the customer. The fact that the options markets quote in $.05 and $.10 increments should **not** be a limitation to BOX from providing price improvement in pennies.

At least one Commentator has stated PIP's can overlap and freeze the market[20]

The possibility suggested here cannot occur on BOX as PIPs will not overlap or queue.

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[17] CBOE letter 2 at 5.
[18] *Attachment,* 5 (ISE letter 1).
[19] AMEX letter 1 at 7.
[20] PCX *Analysis of Specific* Box Rules, 9 (appendix to September 15, 2003 Letter from Philip Defeo, Chairman and Chief Executive Officer, PCX, to Margaret H. McFarland, Deputy Secretary, Commission regarding **SR-BSE-2002-15,** ("PCX letter 2").

Some Commentators have suggested the proposed BOX Rules violate the Act's prohibition against unfair discrimination between customers, issuers, brokers or dealers because only Market Makers can participate in PIP auctions (and in pennies) and not other broker dealers and customers.[21]

The decision to allow BOX Market Makers to participate in PIPs initiated by OFPs is to provide an incentive for BOX Participants to become Market Makers. Other options exchanges protect their Market Makers from direct competition from public customers by preventing customers from electronically generating and transmitting orders and preventing them from sending orders on the same side of the market in the same class within fifteen seconds. There is no such "protection" on BOX. Additionally, all existing floor-based options exchanges require that one must be in the crowd to bid or offer during the exposure period of a facilitation order.

Nonetheless, BSE has determined to institute a set of Rules, which would allow OFPs' access to the PIP on behalf of public customers. The Exchange has amended its proposal to add a new paragraph to BOX's Rules governing the PIP. This new paragraph provides that OFPs may access the PIP on behalf of customers that are not broker-dealers (i.e. public customers) via a new order type, the CPO. CPOs shall include terms stating a price in standard increments ($.05 or $.10) at which the order will be placed on the BOX Book as well as a price in pennies at which the public customer wishes to participate in any PIPs that may occur while his/her order is on the BOX Book. In order for a CPO to be eligible for participation in a PIP, the CPO Book Reference Price must be priced at the BOX BBO. If a PIP commences in a relevant series and the CPO Book Reference Price is at the BOX BBO, then the OFP may, on behalf of the public customer, submit the CPO to the PIP for participation. Upon submission, the CPO will be treated similar to a Market Maker Improvement Order in the PIP.

The Exchange feels this provision will permit public customers greater control and flexibility in how their orders are handled on BOX. Public customers will be able to participate in PIPs and receive the enhanced price improvement opportunities, which PIPs offer. In addition, the Exchange believes offering OFPs the prospect of this service on behalf of public customers will serve to increase the number of participants competing in PIPs ultimately leading to greater price improvement for orders on BOX.

The fact that the CPO must have been already booked on BOX at a limit price equal to the BOX BBO in order to be permitted to participate in a PIP from the firm side of the PIP is not overly restrictive. On the contrary, this is compatible with BOX's goal of encouraging all market participants to place their best price on the BOX Book in order to provide liquidity to the BOX Market. The BOX Book rewards this activity through the use of anonymous price time priority.

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[21] *Attachment, 5* (**ISE letter** 1). *See also* **CBOE letter** 1 **at 4 –5; PHLX letter** 1 **at 1,4.**

In addition, the BSE has determined that increased participation in the PIP by those OFPs who have proprietary orders at the top of the BOX Book would benefit the overall price improvement opportunity available in the PIP. Therefore, the Exchange is proposing a new type of order, a PIP Proprietary Order ("PPO"). Any Options Participant would be able to enter a PPO for their proprietary account into a PIP provided that, (a) they have a resting order on the BOX Book equal to the BOX BBO, and (b) the size of the PPO is no greater than the lesser of the size of the proprietary order on the BOX Book or the size of the Primary Improvement Order. The BSE notes that allowing access of market participants who are quoting at the BOX's BBO is a provision which is similar to existing options exchanges' firm facilitation rules. **Also,** similar to Improvement Orders in the PIP, the price of the PPO could be dynamically improved during the PIP.

On BOX, there are very low barriers to becoming a BOX Market Maker, particularly as compared to the existing options exchanges. Market Makers are not required to buy or lease memberships. Transaction and registration fees for Market Makers will be very low compared to other options exchanges. Furthermore, the wide range of Market Maker interest already generated by the expected launch of BOX increases the likelihood the PIP process will be vigorous and will result in prices to the customer which will not only be fair in the vast majority **of** cases but superior to the prices offered on the other options exchanges.

One options exchange has suggested the CPO should be allowed to compete on the 'must be filled side" (e.g. the "client side") of the PIP since his PIP reference price may otherwise be "traded-through".

While intuitively appealing at first glance, a deeper understanding of the PIP shows why there is not an issue with the fact that the Exchange does not permit CPO's to compete on the client side of the PIP. First, a PIP trade execution, which occurs at a less favorable price than a CPO's PIP reference price is **__not__ a** trade-through in the InterMarket Linkage ("IML") sense of the word since the PIP reference price is not a firm quote visible to other parties. More importantly, it is not coherent with the PIP logic to permit this competition on the client side of the PIP as this would negate one of the key advantages of the PIP, that the "must be filled side" is what its name suggests - it must be filled.

CPOs on opposite sides of the options market on the same instrument cannot trade with each other despite the fact their respective PIP reference prices are executable against each other.

The CPO is designed to allow a public customer order to compete in a PIP. The restrictions on such an order entering a PIP on the same side as the client were discussed above. In order for two CPOs to trade against each other without a PIP having commenced, the BSE would have to adopt trading in pennies for the BOX Book. Such is not the Exchange's intention at this stage; penny increments are restricted to PIP orders.

It is suggested that under Section 11(a) of the Act and Rule 11a-1 thereunder Market Maker or OFPs initiating PIP orders must always yield priority to CPO orders in the PIP.[22]

Among the transactions excepted under Section 11(a)(1) of the Act are those, affected by a dealer acting in the capacity of a Market Maker. A BOX Market Maker who is registered as a Market Maker in an options class has the same affirmative and negative obligations under the BOX Rules as the existing options exchanges' Market Makers and can take advantage of this Market Maker exemption from Section 11(a), at least for securities in which they make a market. In addition, like a specialist who stops an order on an options exchange, a BOX Market Maker submits a directed customer order to the PIP in order to seek price improvement. Therefore, the BOX Market Maker is acting in the capacity of a Market Maker and the PIP transaction is an exception to Section 11(a).

The Exchange has amended BOX's Rules to provide that OFPs initiating PIP orders must always yield priority to public customer orders in the PIP and believes the PIP is consistent with Section 11(a) of the Exchange Act and Rule 11a-1 thereunder.

Some Commentators argue the three-second duration of the PIP is too short, although ISE agrees this is sufficient time for a vigorous electronic auction.[23]

Unlike facilitation processes on other options exchanges, the PIP process is only a mechanism to determine the best price for an order that has been stopped and guaranteed execution at a price already a penny better than the NBBO. Thus, PIP orders are firm and cannot be cancelled at any time during the PIP. The firm, not the customer, bears full risk that the market may move against it prior to the conclusion of the PIP. The Exchange strongly believes an exposure period greater than three-seconds would pose an untenable risk for the initiating firm.

A review of existing technologies demonstrates three-seconds is a sufficient interval for a vigorous multi-round price improvement auction. In market simulation testing, BOX has repeatedly determined there can be at least six iterations of a trade in a three-second period versus usually two on the existing options exchanges, notwithstanding the level of automation. Primarily, this is because the existing options exchanges have only slight variations on a common market structure, as opposed to BOX, which offers an innovative marketplace in which customers are guaranteed meaningful price improvement regardless of differing levels of automation.

PIP processing is not reliant on OPRA or any outside entity. The NSC system-trading engine (the core trading system of BOX, designed by ATOS/EuroNext), in the vast majority of cases,

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[22] **ISE letter 2 at 2-3.**
[23] ***Attachment*, 5 (ISE letter 1).**

can process orders in less than one quarter of a second. Moreover, there are no technological barriers that would prevent a Participant from accessing the PIP or possessing the technological means by which to meaningfully participate in the PIP. Firms that choose not to develop their own software to manage the PIP can contract with one of the many Independent Software Vendors ("ISV") who are either already connected or in the process of connecting to BOX. In fact, at least four "off-the-shelf' software vendors are already certified by BOX to handle the PIP.

It has been asserted BOX violates the Commission's principle that only 40% of an order can be "guaranteed" – because an OFP that initiates a PIP can retain 40% and 20% can be retained by the MMP.[24]

The Commission has consistently applied the policy that only 40% can be guaranteed for allocation based on the status or registration of the firm trading against the order (internalizer or facilitator or specialist) and that at least 60% should be left to crowd competition. On BOX, the 40% allocation to the PIP initiating firm is never guaranteed. The initiating firm may get less or may get nothing depending on competition from other participants. This is in contrast to all other option exchanges, where the initiating firm has a last look opportunity to match or better the crowd's price and guarantee its participation in the trade for at least 40%.

The MMP is a member of the crowd. The MMP's status is set order-by-order and based on competition. On BOX, MMP is not a fixed status – *i.e.*, the MMP is not being rewarded with a fixed percentage for bringing an order like an OFP or because it paid for the monopoly right to the post like specialists on the existing options exchanges. No one can apply for and be approved as a MMP. Any Market Maker in the crowd can be the MMP for any PIP order if that Market Maker was willing to be first to set the NBBO. Presently, there is no inter-exchange time priority and with little intra-exchange competition to tighten the NBBO, the MMP mechanism will enhance the quality of the entire options market as it offers a true incentive to be the first to establish the NBBO.

On the existing options exchanges, the allocation remaining after the specialist has taken its share is based on mechanisms that are less competitive than BOX, such as passive Auto-Ex wheel systems, which allocate portions not retained by the specialists through predetermined non-competitive practices. In contrast, BOX uses MMP and price time priority in the PIP to allocate the 60% that the PIP initiating firm cannot keep.

It has been argued PIPs should not be permitted unless there are at least five Market Makers continuously quoting in a particular series.[25]

[24] *Id.* at 10.
[25] *Attachment,* 10 (ISE letter 1).

There is no logical or statutory basis, nor any empirical support for concluding that five Market Makers are necessary to ensure vigorous competition in the PIP. At least one Commentator has attempted to set forth as fact several anti-competitive wish-list items. These anti-competitive wish-list items have no basis in law or reality. One such anti-competitive wish-list item is the suggestion there be five Market Makers quoting in order to commence a PIP. The Exchange has independently determined it will require a minimum of three Market Makers quoting in a relevant series before a PIP can commence and this requirement has been specified in BOX's Rules. This will provide meaningful competition. Given the level of interest demonstrated at both the Market Maker and OFP levels, competition will most likely be easily achieved by participating on BOX. Requiring a minimum five Market Makers quoting in order to commence PIP could lead to the unavailability of price improvement to customers executing trades in less popular, less liquid classes.

Regardless of the number of Market Makers in the series, BOX's PIP orders are guaranteed to get better executions than orders sent to any of the other options exchanges. This is because the minimum PIP price is pegged to a price set by all the Market Makers in the entire national options market and then enhanced by at least one penny. It is easy to see why PIP is viewed as such a threat to the existing options exchanges. It is a stark contrast to how the existing options exchanges operate. On existing options exchanges, the customer will only get the NBBO regardless of the number of Market Makers in the crowd. Consequently, the customer can never get better than the NBBO. Moreover, in an anonymous electronic trading environment like PIP, there is no potential for intimidation of bidders or collusion among bidders. Therefore, the likelihood is low that even a single Market Maker would not participate in a PIP, thereby allowing the PIP initiating firm to obtain an overly favorable price.

It is suggested BOX's PIP Rules give an OFP a "Last Look" at PIP orders. This would allow an OFP to enter a low initial PIP price and then simply match for 40% at the end.[26]

On BOX, neither an OFP nor a Market Maker has a right, or ability to bid or offer "last" nor to bid or offer after the PIP period has ended. Improvement Orders arrive at random times. There are no technological means to guarantee the "timing" of any order entered so it will be the last order received by BOX at the conclusion of the PIP.

The ability to enter a low initial price is not possible on BOX's PIP because the auction starts at one penny better than NBBO. Each modified Improvement Order in PIP takes an uncertain period of time to be generated and then processed by BOX's Trading Engine, even those created pursuant to a programmed algorithm. The uncertainty is due to the fact that the time period for the acceptance and processing of orders varies with the volume and activity on BOX at any given moment. In the time it takes to modify the Primary Improvement Order, another order can be

[26] *Id.* at6-7.

received by BOX bettering the price. This would occur before a modification can be made to the preceding price improvement order under the three-second time limit. Other such examples abound and prove that there are simply too many systemic and other variables for a PIP initiator to guarantee any type of last look execution.

In a related comment, it has been suggested that a PIP originator can "put on his hedge" early since he is guaranteed 40% of the PIP allocation.[27] As stated above, this is not true because there is no way to guarantee a 40%, or any percentage, of an allocation from a PIP. A PIP originator whether an OFP or a Market Maker is only entitled to a 40% allocation at the conclusion of a PIP if he has matched the execution price of the PIP. This is by no means a certainty and if the PIP originator executes his hedge early, he risks not having the transaction that was the impetus for the hedge. Moreover, on all other options exchanges there is an advantage to putting on a hedge early since the originator of a cross transaction can cancel an order if the market moves contrary to his order. This is not possible on BOX.

It has been suggested it is too easy for firms to internalize <u>outside</u> the PIP mechanism because there is no waiting period for a firm to enter orders that would cross on the BOX Book. Accordingly, it is speculated BOX Market Makers could see an incoming order and move their better quote, put the customer order in, and subsequently trade against it at a worse price.[28]

The scenario described is not permissible under BOX's Rules.[29] BOX Market Makers are bound by the affirmative and negative obligations specified in Chapter VI, Section 5 as well as the specialist obligations in existing Exchange rules that are cross-referenced in BOX's Rules pertaining to trading. A BOX Market Maker could not look at an order and then adjust its quote before putting the order on the book.

Moreover, the Exchange has created Directed Order Rules as discussed in the "Customer Priority/Chinese Walls" section below, which specifically prohibit the kind of behavior suggested.

Commentators have opined PIP executions might create trade-throughs as the PIP process takes three-seconds to complete and the NBBO may change during that period.[30]

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27 ISE letter 2 at 2-3. *See* also CBOE letter 1 at 5-6.

28 *Attachment,* 9 (ISE letter 1).

29 BOX Rules Chapter 5, Section 17; Chapter 6, Section 5.

30 CBOE *Comments on File No. SR-SBE-2002-15*, 9 (attachment to September 16,2003 Letter from William J. Brodsky, Chairman and Chief Financial Officer, CBOE, to Jonathan Katz, Secretary, Commission regarding SR-BSE-2002-15, ("CBOE letter 2").

A PIP execution cannot trade-through another market center because the execution of a PIP order is considered executed at the commencement of the PIP. A PIP order effectively is "stopped" upon the commencement of the PIP. Since a PIP commences at a price, which is at least $.01 better than the NBBO, there is no possibility of a trade-through.

Numerous national securities exchanges have rules governing stopped orders. Essentially, each of the rules says the same thing – granting a "stop" constitutes a guaranteed execution at the stopped price or **better.**[31] With respect to "fill or kill" orders, the rules of many national securities exchanges, including the BSE, consider a "stop" an execution. For example, both the NYSE (Rule 13) and BSE (Chapter II, Section 3) in their definitions of "fill or kill" orders state that "[f]or purposes of this definition, a [stop] is considered an execution." All orders submitted to the PIP will either be filled in their entirety at the best available price or the order will be cancelled (killed). Therefore, to the extent that orders submitted to the PIP are considered "fill or kill," such orders will be deemed by the Exchange to be executed at the time the stop is granted and the price is guaranteed, which is the beginning of the PIP auction process.

In Commission ***Staff Legal Bulletin 12: Frequently Asked Questions About Rule 11Ac1-5*** (updated September 6, 2001), by the Commission's Division of Market Regulation, the following Q&A appears:

> Question 15: Time of Execution for "stopped" or "Guaranteed" Orders
>
> Q: Is it permissible for a market center to assign an execution time to orders when they are "stopped" or "guaranteed" an execution at no worse than a specific price and later assigned a specific execution price?
>
> A: Yes. The statistical measures required by the Rule may be calculated using the **guarantee time as the time of order execution,** [emphasis added] but only under the following conditions. First, the guarantee must be made pursuant to an SRO rule setting forth the standards for guaranteed or stopped executions. Second, the customer must be immediately informed of the guarantee and the guarantee price. Third, the guarantee must be final with no opportunity for rescission. Finally, the guarantee price must be no worse than the Consolidated BBO at the time of order receipt and for the full size of the order.

All PIP orders will meet the conditions set forth by the Commission staff in the answer to Question **15,** above. The guarantee will be made pursuant to BSE and BOX Rules regarding "fill or kill" orders, stops, and the PIP auction process. The BOX reporting system will immediately inform a customer of the PIP guarantee and any improved price gained during the PIP. Under the BOX Rules, PIP initiators cannot rescind their Primary Improvement Order and they must

[31] **For example, NYSE Rule 116 states "an agreement to [stop] securities at a specified price shall constitute a guarantee of the purchase or sale by** him **of the securities at that price or its equivalent." Similarly, AMEX Rule 109 states that a "stop" constitutes a guaranteed execution at the stopped price or better.** ***See also*****, PHLX Rule 220, CHX Rule 22, and BSE Rules, Chapter 11, Section 38, among others.**

guarantee a price at least $.01 better than the NBBO at the time BOX receives the customer order (*i.e.* the beginning of the PIP process). Since a PIP trade will meet all of these conditions, the Exchange believes that BOX should also be able to use the "guarantee time as the time of order execution" for PIP trades.

As a result, the BSE considers that the time of execution for the stopped or guaranteed customer order submitted to the PIP auction system is the time the PIP order was stopped at the beginning of the PIP auction process. In addition, since all PIP orders are guaranteed an execution better than the NBBO at such time there will be no chance for an intermarket trade-through under the Options Intermarket Linkage Plan (the "Plan").

CHINESE WALLS – DIRECTED ORDERS

It is suggested that BOX's Rules allow Market Makers generally to receive and handle order flow and to act as dealer and agent without any Chinese Wall protections.[32]

The Exchange adopted BOX's Chinese Wall Rules directly from approved rules applicable on the other options exchanges. The BOX Rules strictly separate market making and order-entry activities as well as the sharing of information. Under the Rules, BOX Market Makers do not receive orders directly from customers. To clarify this intention that Market Makers would only be able to handle on an agency basis orders directed to them by OFPs, the Exchange changed "Customer Order" to Directed Order in the proposed BOX Rules, which address information barriers. In the Definitions section of the BOX Rules, a Directed Order is defined as an order directed to a Market Maker by an OFP. While an OFP is permitted under the BOX Rules to trade on a proprietary basis with a customer order, it nonetheless may decide not to submit a customer order to the PIP. Instead the OFP may send a Directed Order to BOX with a designation of the Market Maker to whom the order is to be directed. BOX would then route the Directed Order to the appropriate Market Maker who would either submit the order to the PIP process or send the order to the BOX Book.

The Exchange has offered further clarification in amending the BOX Rules concerning how a Market Maker may interact with the Directed Order if the Market Maker chooses to put the order onto the BOX Book. Under the amended rules, a Market Maker has two choices when it receives a Directed Order: 1) enter the order into the PIP; or 2) enter the order onto the BOX Book. Due to concerns regarding informational barriers and the transfer of information, intended or not, which may accompany a Directed Order, the Exchange would prohibit a Market Maker from rejecting or canceling a Directed Order. BOX Rules have been amended to provide for three-seconds to process Directed Orders into either a PIP or a decline to PIP and return of the order to BOX's Trading Engine. Furthermore, this allowable processing time will be system enforced by BOX's Trading Engine.

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[32] ISE letter 1 at 1.

If a Market Maker chooses to place a Directed Order onto the BOX Book, rather than into the PIP, the Market Maker would be prohibited from interacting with that order until it has been exposed to the market for three-seconds. When the Market Maker's quotation on the opposite side of the market from the Directed Order is equal to the NBBO, the Market Maker must submit the Directed Order and a Guaranteed Directed Order ("GDO") for the same price and size as his quotation. A GDO guarantees that after the three-second exposure to the market the Market Maker will execute any remaining quantity of the Directed Order at the NBBO price, which existed at the time the Directed Order was sent. When BOX receives the Directed Order it would immediately execute any orders on the BOX Book against the Directed Order on a price-time priority basis. However, BOX would ensure that the GDO would yield priority to all competing orders at the same price for three seconds. After execution against the GDO and provided that there is still any quantity remaining of the Directed Order, it would be filtered against trading-through the NBBO according to the filtering procedures set forth in Chapter V, Section 16(b) and if applicable, placed on the BOX Book.

The Exchange believes the exposure of the Directed Order to the market will serve to ensure a Market Maker would not be able to act against the Directed Order using any privileged or other information regarding that order. In addition, the Exchange has eliminated certain exemptions in BOX's Informational Barriers Rules to clarify that Market Makers must comply with all provisions of the rules when they receive and handle Directed Orders.

Despite the efforts of the Exchange in clarifying the Directed Order process, some Commentators have suggested that there be an additional requirements imposed. They suggest that a Market Maker must be quoting at the NBBO in order to receive a Directed Order.[33] The adoption of such a proposal would pose an unreasonable burden on Market Makers since in a fast and competitive options market with multiple and competing Market Makers there will often be short periods where even an aggressive Market Maker does not have a price equal to the NBBO. Imposing the condition suggested would simply cause customer orders to miss out on price improvement opportunities. As a BOX Market Maker is rewarded with time priority execution on marketable orders and MMP status during PIPs, there is already a significant incentive to post prices equal to the NBBO.

Commentators have also suggested, in the context of the Directed Order Rules that a Market Maker could choose to opt out of a Directed Order. That is a false assumption. The Directed Order Rules were designed so that a Market Maker does not have the discretion about whether to opt out of a particular Directed Order and thus have the potential to act on material, non-public, or privileged information in relation to that Directed Order. However, any Market Maker can choose to opt out of accepting Directed Orders on a binary basis, which is to say, not receive any Directed Orders. There is no requirement that a Market Maker must receive Directed Orders, but once a Market Maker receives Directed Orders it cannot choose which Directed Orders to accept.

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[33] ISE letter 2 at 7.

The only choice a Market Maker has is whether to receive all or nothing. Moreover, there is no additional hidden type of order as some Commentators have suggested in questioning whether internally disseminated BOX documents detail such order types. For instance, an internally designated "routed order" is not another order type for which a Market Maker has Directed Order responsibilities. Commentators can be assured the Exchange is fully complying with the Commission's requests and not attempting to subvert the rule approval process.

BOX MARKET MAKERS TREATED AS SPECIALISTS

Some Commentators have suggested that BOX Market Makers get the benefit of being treated as "specialists" under the Act (such as being allowed to continue to trade where they are involved in an underwriting in the security) without suffering the burdens.[34] One Commentator even suggested BOX Market Makers are not taking sufficient risk to justify the preferential tax and margin treatment offered to Market Makers in exchange for their risk taking behavior.

BOX Market Makers have similar affirmative and negative obligations regarding quoting and maintaining a market as specialists (See, e.g., BOX Rules Chapter VI, Sections 5,6). In fact, BOX Market Makers are actually disadvantaged compared to their counterparts on other options exchanges due to the fact that BOX Market Makers do not control the time and place of execution as do Market Makers on other options exchanges. The possibility they might be able to step in front of a customer's order is therefore less of a possibility than on the other options exchanges. BOX designates Market Makers as specialists for ease in applying relevant Exchange Rules, which denote "specialists," as opposed to "Market Makers." It is the same approach the Exchange used to make its general rules regarding specialists applicable to member firms who trade Nasdaq securities and who otherwise might be referred to as Market Makers (see Exchange Rules, Chapter 35). BOX Market Makers have similar affirmative and negative obligations regarding quoting and maintaining a market as specialists.

BOX Market Makers would be taking sufficient risk to justify preferential tax treatment afforded to Market Makers on other options exchanges. The Exchange notes BOX Market Makers, like all dealers under the Act, are required to create a market in the securities they represent in the marketplace. BOX Market Makers have the same risk levels in the marketplace as do the Market Makers and similarly designated dealers on the other options exchanges. On BOX, their risk profile is actually higher than similarly situated dealers on other options exchanges because they do not have the ability to control the time and place of an execution. Therefore, BOX Market Makers are entitled to at least the same margin and tax treatment as other options exchanges' Market Makers as they would be taking sufficient risk to justify preferential tax treatment afforded to Market Makers on other options exchanges.

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[34] *Id.* at 15-16.

<u>BEST EXECUTION</u>

Some Commentators have suggested a broker-dealer would violate its duty of best execution by sending a non-marketable limit order to BOX rather than other options exchanges. In this vein, the ISE opined that on other options exchanges the customer order would have priority?'

A broker-dealer would not violate its duty of best execution by sending a non-marketable limit order to BOX rather than other options exchanges. The duty of best execution allows broker dealers to look at the totality of circumstances surrounding the various market centers where an order could be executed. Firms make their order routing decisions based on weighing a variety of factors such as price, speed of execution, order size, opportunity for price improvement, certainty of execution, or liquidity. One could make an argument that it would be a violation of best execution to ever send an order to an options exchange that was not fully electronic because speed of execution or certainty of execution is poor, but this of course is not what best execution means. Best execution allows the broker to take into account all relevant factors of his/her customer orders. Firms are not required to look at each order and make a decision based solely on one particular hypothetical factor. Where to send a particular order will depend on what the options exchanges' prices are, who is quoting those prices, and how far away from the market the customer's non-marketable limit order is, among other factors stated above.

If best execution relied on just one factor as the ISE suggests, then BOX could argue that since only BOX offers an opportunity for guaranteed price improvement to customer orders and would provide a filtering mechanism to limit trade-throughs (See discussion of IML, below), firms would be violating best execution by sending customer orders to the ISE or other options exchanges. It is not necessarily the case the customer will be better off if his/her order is sent to another options exchange where it would have priority at that options exchange. On other options exchanges, the order may not be eligible for electronic execution when it becomes marketable so having priority will not necessarily make a manual execution of an order on another options exchange faster than an electronic execution would have been on BOX even if a professional order is executed first on BOX.

On the floor-based exchanges, the customer loses control of their limit order and – because of manual processing – cannot necessarily cancel the order if the market moves against him. In fact, when the market starts to move in favor of the specialist and against the customer, the specialists tend to get slower to process cancellation requests. On the BOX Book, orders and quotes are anonymous. The broker retains control over the resting limit order of the customer and can cancel it at their request. Moreover, broker-dealers currently have no way of knowing

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[35] ISE letter 2 at 2.

on which options exchanges a non-marketable order would have priority if it was sent there. Likewise, since there is no inter-exchange priority, a broker-dealer under the current system has no way of knowing to which options exchange it should send a non-marketable order (*i.e.*, on which options exchange the order will become marketable first).

The PCX's Archipelago Exchange has price/time priority rules similar to BOX and has been fully approved by the Commission. If it does not constitute a violation of best execution principles to submit orders to Archipelago Exchange, then it would not constitute a violation of best execution principles to submit orders on BOX.

INTERMARKET LINKAGE PLAN

Other options exchanges propose the flat and open model of BOX is not consistent with the Plan because under the Plan there is a specialist who is responsible for dealing with the Plan issues. The ISE believes that only specialists who have spent significant amounts of money to purchase or lease trading rights should be allowed to send orders through the Plan and that BOX cannot allow all Market Makers to do so.[36] It has also been asserted the Exchange's intention is to have BOX manage the physical transmission of Principal ("P") and Principal as Agent ("P/A") orders to other options exchanges somehow interferes with the agency duties of Market Makers.[37]

BOX should not be required to adopt the exact same market model as existing options exchanges. By putting forth this argument, existing options exchanges are attempting to use IML as a weapon to forestall competition and innovation by claiming the Plan essentially requires all new exchanges to adopt the exact same market model as existing ones. IML was designed to protect customers not the existing options exchanges. From its inception, BOX has agreed with the goal of IML to protect public customer orders from receiving anything less than the best price available across all the options exchanges.

BOX believes the IML should not be used by its competitors to coerce BOX into adopting a market structure similar to those already in existence on other options exchanges. The Commission should not sanction the use of IML as an anti-competitive weapon by existing options exchanges whose sole interest is to protect and further their franchises and suppress competition and innovation by new exchanges. The IML must accommodate different market structure mechanisms of various participants and cannot be read to force identical market structures. BOX does not deny for one moment it is very "different" from the existing options exchanges. This does not mean it cannot meet the requirements of a "Participating Exchange" in IML.

[36] ISE letter 2 at 13-14. See also CBOE letter 1 at 8-9; PHLX letter 1 at 6.
[37] ISE letter 2 at 2.

The Plan provides for Eligible Market Makers ("EMM") to submit orders through the Plan. Since BOX Market Makers have the same obligations **as** other options market makers, including the responsibility of providing two-sided quotations, they should be considered EMMs under the Plan and have the same access and responsibilities **as** specialists or DPMs and other **EMMs.**[38] In addition, P/A orders (and indeed P orders) from away exchanges will have complete unfettered access to the BOX Book **as** though they were submitted by BOX Participants. There will be no fading (indeed there cannot be any fading of quotes on BOX) and these orders arriving on BOX via IML are welcome to take the entire quantity available if they choose to without any delay. There is no reason to have "someone responsible" for incoming P/A orders.

As to Satisfaction orders, BOX's Rules are quite clear. Any BOX Participant determined to have traded-through an away market and for whom, subsequent to such trade, the BOX Market Operations Center ("MOC") receives a valid Satisfaction request, will be automatically assigned the additional trade execution by BOX MOC. The offending BOX Participant will be obliged to trade with the Satisfaction request at the price and for the quantity provided for in the Plan.

At the behest of the Staff, the Exchange has submitted rules addressing how BOX will participate in IML, which are substantially similar to the rules currently in place on other options exchanges. In addition, the Exchange designed and proposes to implement a unique order filtering mechanism on BOX, which will prevent incoming customer orders from trading-through the NBBO. This is a step no current member of the IML has taken to reasonably limit trade-throughs. All in-bound orders to BOX from customers will be filtered by BOX prior to entry on the BOX Book in order to ensure these orders will not execute at a price outside the current NBBO. In this manner, the Exchange has added an extra level of efficiency to BOX's Trading Engine, which will serve to enhance both the best execution of orders **as** well **as** BOX's participation in the IML. The filter will operate by analyzing each in-bound customer order. The filter will determine if the order is executable against the **NBBO and** whether there is a quote on BOX, which is equal to the NBBO.

If there is not a quote on BOX, which is equal to the NBBO, then the order is exposed on the BOX Book at the NBBO for a period of three-seconds, during which time any Options Participant may execute against the order. At the conclusion of the three-second period if there is any unexecuted quantity, then in the case of public customer orders, a P/A order will be generated and sent to the away options exchange displaying the NBBO.

The existing options exchanges have commented that BOX's intention to expose inbound P and P/A orders for three seconds at a price equal to the NBBO is inconsistent with IML Plan. ***As*** a matter of clarification, any inbound P or **P/A** order that **has** a limit which **is** not immediately executable against the best BOX price on the opposite side of the market will be rejected

[38] **Section 2 (7)(Definitions), Plan for the Purpose of Creating and Operating an Intermarket Options The Plan, Securities Exchange Act Release** No. **46001 (May 30,2002).**

immediately back to the originating exchange. If an inbound P or P/A order is executable against BOX, the Exchange has determined that it will eliminate the three-second-exposure period and execute the order immediately. BOX believes this is entirely compatible with IML and apologizes for any confusion, which was largely due to having received detailed information on IML rather late in the project.

Moreover, it has been opined that BOX should not be able to route P/A orders to away options exchanges on behalf of BOX's Market Makers because this somehow interferes with the agency obligations of the Market Maker. That is, if there is more than one away options exchange at the NBBO with a quotation size which would satisfy all or part of a BOX's P/A order, it is argued the BOX Market Maker should decide to which exchange the PIA order should be sent. BOX Market Maker's agency obligation is to fill his/her customer's order at the best available price. The Exchange has amended its proposal to clarify that BOX's Rules and system clearly provide for this, and therefore the Market Maker will satisfy his/her agency obligations. The Market Makers' agency obligation will be effected through the forwarding of their instructions to the BOX MOC and any discretion is removed from BOX.

BOX will not itself decide where to route P/A orders in the case where multiple options markets are posting the NBBO. The BSE is specifically defining a BOX InterMarket Linkage Market Maker ("BIMM") as the BOX Eligible Market Maker designated with the responsibility for settling PIA and Satisfaction orders that would be sent to away markets through the InterMarket Linkage for a given class on BOX. To ensure that there is an Eligible Market Maker per Eligible Class (as those terms are defined in the IML) for the submission of P/A and Satisfaction orders to away markets, BOX would specifically designate a BIMM in each Eligible Class traded on BOX responsible for such orders. The BIMM would adhere to the responsibilities of an Eligible Market Maker as set forth in the IML.

The BIMM would be required to act with due diligence with regard to the interests of orders entrusted to him and fulfill in a professional manner all other duties of an agent, including, but not limited to, ensuring that such orders, regardless of their size or source, receive proper representation and timely, best possible execution in accordance with the terms of the orders and the rules and policies of the Exchange. In order to enable the BIMM to carry out its agency responsibilities with respect to P/A orders submitted through the IML, the BSE would require that a BIMM must submit prior written instructions to BOX regarding the routing of any PIA orders which the Market Maker would send through the IML. BOX would immediately route all P/A orders on behalf of the Market Maker according to these instructions. The order would be generated automatically by BOX and routed to the away exchange with the required BIMM, clearing and valid-clearing-firm ("VCF")information included. Each execution received from an away exchange would result in the automatic generation of a trade execution on BOX between the original public customer order and the BIMM.

Finally, there has been suggestion that P/A orders will only be generated on BOX when a Market Maker finds an order "unattractive". On BOX, there are only two kinds of orders: immediately executable and not immediately executable. If by "unattractive", Commentators mean P/A orders will be generated if a BOX Market Maker is not willing to be at the NBBO, then the Exchange agrees. A BOX Market Maker will generate a P/A order if another options exchange is posting the NBBO. The Exchange is operating under the assumption this is the intention of the Plan and if an options exchange is posting the NBBO, then a Market Maker on that options exchange wants orders to be sent to that quote and is eager for the orders.

With regard to the order that is "exposed" on the BOX Book as part of NBBO filtering process, some Commentators have asked which BOX Participants will be able to view the internal message disseminating the order at the NBBO for three seconds.[39]

All BOX Participants receiving the BOX broadcast feed can see all of these exposed orders which are available to all BOX Participants for execution on a first come, first served basis. This is certainly an improvement from most other options exchanges where this information is reserved for the specialist or Market Makers present in the crowd. These exposure orders are not transmitted to OPRA as they would by definition result in a locking of the NBBO.

How will BOX execute Satisfaction requests if it executes a block size trade-through in the PIP?[40]

All PIP executions, including those of block size, are improvements of the NBBO and by definition would not create trade-throughs under the IML. BOX does not have a block-trading rule in its current proposal and would therefore never exercise the right to trade outside the NBBO in the PIP process.

BOX-Top Order is incompatible with IML as it will result in locked NBBO.

This is simply untrue. Any unexecuted portion of a BOX-Top Order, which would lock the NBBO is first exposed in the filter's three second exposure period and if there is any quantity remaining and there is still a better price away at the end of the exposure, a P/A order will be generated.

BOX has not explained how the IML Market Makers will be selected and what may be their privileges.

The Plan provides for Eligible Market Makers to submit orders through the IML. Since BOX Market Makers have the same obligations as other options market makers, including the responsibility of providing two-sided quotations, they should be considered Eligible Market Makers under the Plan as long as they satisfy the requirements pursuant to the Plan, and should have the same access and responsibilities as other options exchange market makers who are

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[39] *PCX Analysis of Specific BOX Rules,* 4 (attachment to PCX letter 2).
[40] *Id.* at 13.

Eligible Market Makers. The BSE notes that the BOX IML Rules are substantially similar to those of the other options exchanges. The Exchange will monitor BOX Market Makers compliance with these requirements. They are afforded no special privileges beyond those of other Eligible Market Makers under the Plan.

BOX DEFINITION OF MARKET ORDERS – POSSIBILITY OF BLANK SCREENS

It has been suggested BOX Market Orders are not really Market Orders because if there is not enough liquidity on the BOX Book to fill the Market Order, the remainder is put on the limit order book. The ISE believes this is inconsistent with the concept of Market Orders which must be executed immediately and in full and that "on BOX, there could be in some series without quotes at all."[41]

If there were no market in a series, an incoming Market Order would be rejected, so there would be no prejudice to the customer. Nonetheless, in order to eliminate any unintended confusion, the Exchange has changed the name of the Market Order. Formerly, the Exchange defined a Market Order as an order, which is "entered into the BOX Book and executed at the best price available in the market for the total quantity available from any contra bid/offer. Any residual volume is automatically converted to a limit order at the price at which the original Market Order was exhausted." Since this definition differs from the commonly used concept of Market Order in the U.S. based options markets, the Exchange has changed the name of this order type to BOX-Top Order, to eliminate the possibility of confusion on the part of investors and other options market participants.

BOX's Market will not have a "Market Order", as that term is typically used, that can be executed at successive price levels. A BOX-Top Order will not receive a price inferior to that which a typical Market Order would have received in BOX's Market. Moreover, as a result of BOX's trade-through filter process (see discussion above) and the IML, no BOX-Top Order will receive a price inferior to the NBBO. Indeed, due to BOX's PIP mechanism, orders submitted to BOX have the potential to be executed at a price superior to the NBBO.

The Exchange believes a typical Market Order has limited utility in a highly liquid market and actually can facilitate the creation of trades-through as the order is subsequently executed at progressively worse price levels. The BOX-Top Order, by getting initially filled at the NBBO up to the amount of the available quantity, and then converting to a limit order, is thereby subjected to BOX's unique NBBO filtering process. As such, the order is prevented from trading-through another options market and is, in fact, executed at the NBBO for any remaining quantity, whether that quantity exists on BOX or in another options market. The Exchange has

[41] ISE letter lat 2; ISE letter 2 at 12-13.

complete confidence in IML and will be utilizing it to help ensure that BOX orders do not trade-through another options market. It is unfortunate Commentators do not indicate this same level of confidence in the IML when they suggest BOX-Top Orders will result in trades-through of other options market centers. In fact, concerns about at-market prices are moot when IML is respected and trades-through are satisfied.

It is highly unlikely that there would be blank screens on BOX. Thirty-two Market Makers have been conditionally appointed to trade in BOX's first 250 classes in anticipation of the BOX launch, five of whom will trade in all 250 classes with in the first six months of launch. An additional sixteen Market Makers have already applied for membership in each class. The Exchange will also actively conduct surveillance regarding Market Maker quoting obligations. Furthermore, there is always the availability of the utilization of a Request For Quote ("RFQ") message if there are no quotes in a particular series (See discussion below concerning RFQ messages).

E ON BOX FOR MARKET MAKERS TO MAINTAIN MEANINGFUL ATIONS AT THE N

There are several meaningful incentives for BOX Market Makers to consistently quote at or establish the NBBO. Primarily, these are related to both the PIP and the Directed Order process, both of which are discussed above. The key differences from the existing exchanges in the BOX market model are: 1) an open and competing Market Maker structure with no specialist/DPM and no regulatory limits to the number of Market Makers appointed on a given class; 2) low costs to enter the market; 3) low transaction costs compared to the other exchanges; 4) price and time priority, and; 5) fully anonymous trading. Each of these, and their combined effect, give BOX Market Makers the incentive to quote aggressively since they are rewarded with priority on any executions. Furthermore, the BOX Market Maker has the means to quote aggressively, since in a truly competitive environment like BOX, the cost savings that BOX Market Makers have vis à vis other Market Marker on the existing options markets will inevitably 'bepassed along to the customer in the form of competitive quotes which will necessarily translate into tighter spreads.

As an example of the low cost incentive offered by BOX, a BOX Market Maker trading on all of the top 600 options classes (BOX will initially only list the top 250 classes) would have to pay to BOX a Minimum Activity Charge ("MAC"), which is fully applicable towards any trading fees owed, of about $ 1.5 million per annum. ISE lessors charge a similar MAC type lease fee, so that the comparable figure to act as a CMM leasing on ISE is (or was before BOX and its low costs loomed on the horizon) approximately three times this figure. In other words, a BOX Market Maker who executes 1% of the total OCC contact volume in the top 600 classes would pay $0.20 per contract traded on BOX while an ISE CMM pays $0.60 per contract on ISE to lease. Since CMM leases typically have a "MAC" equivalent to 3% of ISE volume and ISE itself is running at slightly over 30% of OCC total volume, these are comparable figures based on third quarter 2003 ISE data.

Moreover, to buy rather than lease the trading rights to all 600 classes on ISE (10 Bins) would cost a Market Maker approximately $15 million (ISE bin sales have been at least $1.5 million each over the last year). A BOX Market Maker does not buy a seat or bin trading right, but is responsible for payment of the MAC.

In order to attract captive order flow currently sent to the existing exchanges, BOX Market Makers will probably have to post prices **better** than the prevailing NBBO (i.e. a nickel or dime better than anywhere else) since, at equal prices, this flow will continue to be routed by brokers to the auto execution system where "his Market Maker" (whether directly associated, or associated via Payment for Order Flow, soft dollar arrangement or other consideration) currently holds the specialist/DPM appointment. At equal prices, the existing exchanges' rules regarding auto-ex wheels and guaranteed specialist/DPM trade allocation are built-in incentives to retain their captive order flow. This holds true for even the BOX owners, whose interest in BOX is outweighed by the advantages these rules provide to the firms. Also, for a couple of the minority owners of BOX, the vast majority of their order flow is the "informed" institutional order flow (non-captive), which will be sent by smart order routers to the exchange with the best prices, which may or may not be BOX.

BOX has attracted 8-10 professional trading firms who have, prior to BOX, chosen not to participate as Market Makers on the existing options exchanges due to archaic and disincenting market structures, but will participate on BOX as Market Makers. A large number of BOX Participants have no order flow relationships, are purely professional trading firms, and therefore must post better prices to capture order flow. For instance, of the **32** firms participating in the recent Market Maker allocation process, over **20 of** them do not have captive order flow. Not only will these Market Makers meet or establish the NBBO to attract order flow but also they will vigorously compete for executions in the PIP.

BOX's price-time priority order matching algorithm is also a significant incentive to being first to post the new best price since a BOX Market Maker will be rewarded with the full (as opposed to shared) trade allocation. In the BOX environment of full automation, which allows the largest firms to deploy their considerable resources and capital to making markets on listed equity options (rather than establishing costly privileges and franchises on the existing exchanges), there is a vast and very important new source of liquidity formation that is concerned only with speed and price of execution, and not antiquated factors such as trade counter party and the related notions of "good and bad order flow". BOX's anonymity fosters this business model.

With the Staffs assistance, the BSE has instituted a number of proposed BOX rule changes, which encourage Market Maker quoting. Key among these is the MMP designation set forth in chapter **V,** Section 19 of the BOX Rules. MMP was developed as a motivation to Market Makers to be first to establish a quote on BOX equal to NBBO (or establishing a new **NBBO).** The mechanism incents Market Makers by guaranteeing **20%** of the trade allocation resulting from a PIP execution provided the MMP had a pre-posted quotation at the NBBO and matched the execution price at the end of the PIP. This is a strong incentive, particularly in the BOX environment with its anticipated average of fourteen Market Makers per class by the end of the first six months after launch (based on Market Maker appointments allocated under the recently approved plan).

The BSE also worked with the Staff to develop BOX rules related to Directed Orders. Under the Directed Order process, Market Makers will need to post quotations at the NBBO in order to increase the probability that after the three-second-exposure period they will retain, through the use of the GDO, all or a portion of any orders directed to them. Also, Marker Makers have an incentive to quote the NBBO in order to intercept Directed Orders sent to other Market Makers when they arrive at the BOX Book.

The BOX Rules and market model stand in contrast to the existing options exchanges, which actually foster disincentives to quote the NBBO. Various mechanisms on the existing options exchanges, such as "wheels", algorithms, bullying, and specialist guarantees, ensure less aggressive quoting by Market Makers since there is no reward for being aggressive. One only has to observe the beneficial effect that ISE had on the NBBO, even with its traditional, specialist-based model, to note the positive effects any type of significant new competition such as BOX would have on the creation of the NBBO.

The auto-ex wheels on the existing options exchanges are a notorious disincentive to Market Makers wishing to post better quotes. With the wheels, orders are automatically and immediately executed at the NBBO. Market Makers have no incentive to better the quote because with the wheels they are not rewarded with the attracted orders. In fact, such attempts to better the quote are met with retaliation by other Market Makers and the specialist/DPM because the other Market Makers and the specialist/DPM on the wheel bear the cost of the improved quote. In addition, the automated step-up and match system is a further disincentive to be first to better quotes because a Market Maker need only match the NBBO after an order arrives at the exchange to gain a portion of the trade allocation. Moreover, on the existing options exchanges, internalization thrives via the captive arrangements for order flow that have been initiated, indeed supported, by exchange sponsored Payment for Order Flow. The existing exchanges foster and encourage internalization without the possibility of improvement to the order, and with no real competition.

SUR FOR BROKER-DEALER EXECU IN EXCESS OF 'WO TIMES CUSTOMER BUSINESS

Concerns have been raised regarding the proposed surcharge against an OFP that executes more than twice as much broker-dealer volume (either proprietary or as agent for another broker-dealer) as customer business is discriminatory and anti-competitive.[42]

[42] *Attachment,* 11-12 (ISE letter 1).

The Exchange realizes that the other options exchanges' have recently moved to treat broker dealer and customer orders similarly, likely in response to the BOX proposal. Therefore, the Exchange no longer sees a need for this provision and has removed it.

A related issue is whether the surcharge imposed on Market Makers for executing trades outside of their class allows Market Makers to "buy" Market Maker status in non-appointed classes. The Exchange has deleted this provision, which imposed a monetary penalty on Market Makers who transacted business in classes outside of their appointments. Rather than a specific monetary penalty, which may have been construed as a barrier to entry to the BOX Market, the Exchange has chosen to mirror provisions common on other options exchanges that permit Market Makers to trade outside of their appointments. This amendment also sets forth an execution percentage requirement that Market Makers must meet within the classes to which they are appointed.

RFQ RULE

Some Commentators have pointed out that the BOX website describes a RFQ mechanism but this is not described in BOX Trading Rules.[43]

BOX's website discusses future business plans as well as various functions of the trading platform that may or may not be utilized on BOX's Market. The Exchange will work with the Commission to make rule filings whenever necessary to support a given function. The ISE has a similar RFQ function but has no rules describing its mechanism. It would be wholly unfair to require the Exchange to a establish rules describing the mechanism for its RFQ function when the ISE has a similar RFQ function but has no rules describing its mechanism yet it is operational.

Regardless, the Exchange has determined to set forth guidelines regarding a Market Maker's obligations in responding to an RFQ. BOX Market Makers undertake a meaningful obligation to provide continuous two-sided options markets. These obligations include the requirement that quotations be for a size of at least ten contracts and within the legal width of the market. Under the amendments to the proposed rules, a Market Maker must respond to a RFQ message within fifteen seconds with a similarly valid quotation. Although the Exchange is confident that it has provided a marketplace, which will be robust and liquid the delineated responsibilities added to this section will serve to guarantee that Market Makers provide liquidity to the options market and do so on a continuous basis.

Moreover, some Commentators have suggested that the fifteen-second time frame provided for Market Makers to respond to an RFQ is too long. The Exchange has re-evaluated its RFQ

[43] *Attachment,* 11 (ISE letter 1).

related rules and is amending its filing to set a three second timeframe for Market Makers to respond to an RFQ.

BOX "MEMBERSHIP" IS LIMITED TO "CUSTOMER RRYING DUAL MEMBER F

It is not the Exchange's intention to limit participation or "membership" on BOX to only "customer-carrying" firms or to only dual members. Market Maker firms that do not also carry customer accounts would be eligible for BOX Options Participant approval as would sole "members" of BOX. In order to eliminate any confusion that may have arisen fiom an interpretation of BOX's Rules, the Exchange has amended the Rules to specify that Options Participants must be registered as broker-dealers. Additionally, the Exchange has clarified that the BOX "Sales Practice" Rules apply only to those Options Participants who are permitted under BOX's Rules to deal directly with the public, that is, OFPs.

MARKET-ON-OPENING ORDERS. ONE COMMENTATOR HAS SUGGESTED THAT THERE ARE SEVERAL AREAS OF CONCERN REGARDING MARKET-ON-OPENING ORDERS, PARTICULARLY IN RELATION TO THE THEORETICAL OPENING PRICE ("TOP").[45]

The Exchange realized in BOX's Rules it had made a typographical error and used the term "Market-On-Open" Order when it intended to use the term "Market-On-Opening" Order. The Exchange has corrected this error so the name of the order in all sections of BOX's Rules is consistent as "Market-On-Opening". In addition, the Exchange notes it has not changed any other parts of the Rule sections pertaining to this type of order including the statement that "BOX will determine a single price at which a particular series will be opened." ***(See*** BOX Rules, Chapter V, Sections 9, 14).

As with the rest of the BOX Market, all BOX Participants can see a TOP. The opening match algorithm, as set forth in the BOX rules, is the price, which results in the most contracts being executed. The first level tie breaker is the price at which the fewest number of contracts will rest on the book after the open. The reference price from the previous close will be used to break any subsequent ties.

It is also suggested that a Market-on-Opening order may "miss an opportunity" due to the possibility of a partial execution. The BSE believes that the opposite effect is an equal possibility. That is, a better execution could just as likely result since an order may be filled just after the opening at its booked limit, rather than responding to prices which are several ticks away from the market at the opening. In any case, however, BOX Market Makers have a

[44] AMEX letter 1 at 2-3.
[45] *PCX Analysis of Specific Box Rules,* 1-2 (attachment to PCX letter 2)

responsibility to ensure an orderly opening, which includes the obligation to monitor for unfilled quantities and providing additional liquidity before the opening match, which should result in all Marketan-Opening orders being filled at the opening.

CONCLUSION

The Exchange is confident that the amendments, which it has made to BOX's Rules sufficiently address the various concerns expressed in several comment letters regarding BOX's Rules proposal. The Exchange is pleased to offer these amendments with the ultimate aim of strengthening the BOX Market to the ultimate benefit of investors. Additionally, the Exchange looks forward to working with the Commission so as to gain timely and final approval for BOX's proposal. As documented response has demonstrated, the investing public is similarly eager.

If there are any questions regarding this letter, please do not hesitate to contact me.

Sincerely,

George W. Mann, Jr.
Executive Vice President
and General Counsel

Cc: Chairman William Donaldson
Commissioner Atkins
Commissioner Campos
Commissioner Glassman
Commissioner Goldschmid

Annette Nazareth
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